PATTERNS IN INVESTMENT FLOWS

Talk to a conference organized by the
Australian APEC Study Centre at Monash University

'Reshaping APEC for the Asia Pacific Century'

Invest Victoria Centre

Melbourne

12th December 2006

by

Saul Eslake

Chief Economist
Australia & New Zealand Banking Group Ltd

Nearly all of the major trends in capital flows within APEC over the past decade have their origins in the Asian financial crisis of 1997-98.

One of the – if not *the* – most important consequences of that crisis was a series of momentous shifts in saving and investment in different parts of APEC (see slide 2).

In 'developing' Asia (which here includes India) investment slumped by 7 pc points of GDP between 1995 and 2000, whereas saving fell by only 2¾ pc points of GDP, so that 'developing Asia' flipped over from being a net capital importer to being a net capital exporter (there were some important differences within 'developing Asia' which I'll come to in a moment).

During the current decade, investment in 'developing Asia' has risen by 8 pc points of GDP – to be nearly 3 pc points of GDP above the pre-crisis peak; but saving has risen even further, by 10 pc points of GDP, so that 'developing Asia' has remained a capital exporter.

In the so-called 'newly industrializing' Asian economies (Korea, Taiwan, Hong Kong and Singapore), investment slumped by around 7 pc points of GDP during and immediately after the crisis; and then fell again during the post-'tech wreck' recession (reflecting the importance of the hi-tech industries to these economies) and has remained low ever since. Saving has also declined in the NIEs since the crisis, but by much less than investment, so that the NIEs have also become significant net capital exporters.

In Japan, both investment and saving (which had peaked at the end of the 1980s 'bubble' economy) continued declining through the crisis and the post-'tech wreck' recession, bottoming out only in 2004, since when saving has risen slightly more than investment: Japan remains a substantial capital exporter.

The outflow of capital from Asia during and after the crisis helped fuel the 'tech bubble' in the US & elsewhere. During and after the 'tech wreck', US savings plunged, while investment dipped briefly and then recovered – so the US has become a huge net importer of capital.

Within developing Asia there have been some important differences between China (and India) on the one hand and other developing economies on the other (see slide 3).

In China, gross investment has risen by over 10 pc points of GDP since the mid 1990s – while has risen (at face value) by an astonishing 18 pc points of GDP over the same period. The source of this rise in saving is the subject of some controversy: World Bank economists Bert Hofman & Louis Kuijs argue that the rise in savings has accrued largely in the corporate sector, as a result of a dramatic improvement in the profitability of Chinese industry[1], a conclusion disputed (for example) by Weijian Shan[2]. Whatever the truth of these conflicting views, there's no doubting that the gap between Chinese gross saving and gross investment – and hence the current account surplus – has risen substantially.

---

[1] Louis Kuijs, 'Investment and Saving in China', *World Bank Policy Research Paper 3633* (June 2005) and 'How Will China's Saving-Investment Balance Evolve?' *World Bank Policy Research Paper 3958* (July 2006); Bert Hofman and Louis Kuijs, 'Profits Drive China's Boom', *Far Eastern Economic Review* Vol 169 No 8 (October 2006) pp. 39-43.

[2] Weijian Shan, 'China's Low-Profit Growth Model', *Far Eastern Economic Review* Vol 169 No 9 (November 2006) pp. 23-28.

Though not shown separately here, I mention in passing that in India, both saving and investment have risen by about 6 pc pts of GDP over the past decade, though the former remains typically below the latter and so India continues to run a modest current account deficit (as most other Asian economies, apart from China, have done at similar levels of development).

The same has also occurred in Vietnam (also not shown here): investment has risen by around 6 pc points of GDP (to 32.4% in 2006, the highest in the region after China); while saving has leaped by an extraordinary 14 pc points of GDP.

Elsewhere in 'developing Asia', the post-crisis decline in investment has *not* been reversed. In Malaysia, gross investment plummeted from a peak of 43% of GDP in 1997 to less than 20% this year; the decline in Thailand was almost as large between 1996 and 1999, but almost half of that has since been reversed. Gross investment also fell by around 16 pc pts of GDP in Singapore. Investment in Indonesia and the Philippines was never as high as in the rest of South East Asia and so didn't fall by quite as much, and remains very weak.

Across South East Asia as a whole, saving has fallen by a lot less than investment, so that South East Asia has also become a net exporter of capital to the rest of the world.

The result of this dramatic swing in saving and investment on either side of the Pacific is of course that emerging APEC economies (which in this chart includes both 'developing' Asia and 'newly industrializing Asia) have become significant net exporters of capital to 'developed' APEC members – mostly the United States but also of course Australia and New Zealand (slide 4) and with the notable exception of Japan.

For most of the 1980s (except for 1986-1988) and the first half of the 1990s, 'emerging Asia' was a net importer of capital – in line with the predictions of economic theory. Capital imports peaked at over US$58bn in 1996.

Since the Asian financial crisis, however, 'emerging Asia' has become an increasingly significant exporter of capital, with net capital outflows exceeding US$100bn for the first time in 2002, topping $200bn two years later and, according to the IMF's most recent *World Economic Outlook* projections, set to exceed $250bn this year and next.

'Emerging Asia' remains a significant net recipient of foreign direct investment. (FDI; slide 5). FDI flows were less affected than other capital flows by the Asian crisis; indeed FDI flows were more affected by the 2000 'tech wreck' and the ensuing downturn in the regional and global economy than they were by the financial crisis.

China has accounted for the lion's share of FDI inflows into 'emerging' Asia – absorbing 57.5% of the total net FDI flow into the region over the past decade with no other individual economy accounting for more than 5% (slide 6).

Some economies remain wary of, or even hostile to, FDI, notably Korea and (at least in respect of some sectors of its economy) India.

Conversely, although it generally welcomes FDI, Indonesia has not had much success in attracting it since the crisis, experiencing net outflows exceeding US$10bn between 1998 and 2003 - although under the Yudhiyono Administration net FDI inflows have again turned positive.

Portfolio capital inflows into ‘emerging Asia’ remained positive after the financial crisis – albeit at markedly lower levels than before the crisis (slide 7).

However these flows reversed during the ‘tech downturn’ of the early years of the present decade and have remained weak ever since – especially if one excludes India which has seen a significant increase in portfolio capital inflows over the past three years.

It was of course the dramatic reversal of ‘other private capital flows’ – in particular bank lending – which was at the heart of the financial crisis. In the three years 1998 through 2000 nearly US$320bn of this form of capital left the region.

Since then bank lending to ‘emerging Asia’ has resumed (on net), dominated by lending to China, and mostly at lower levels than before the Asian crisis.

With private capital flows to emerging Asia remaining generally positive (except for 1998), Asia’s net capital exports to the rest of the world have been overwhelmingly in the form of official reserve accumulation (slide 8).

Some (most famously Ben Bernanke[3]) have argued that Asian governments have explicitly sought to accumulate much greater levels of official reserve assets than previously thought prudent, as a form of ‘insurance’ against the recurrence of another financial crisis; and that, in order to achieve this objective, have consciously sought to keep investment subdued so as to ensure large current account surpluses which they have in turn ‘raked off’ into their central banks (in the form of FX reserves) by intervening in currency markets to prevent their exchange rates from appreciating against the US$.

Between 1999 and 2005, Asian central banks (excluding Japan) accumulated nearly US$1¼trn in official reserves, and are likely to have accumulated almost another US$350bn in 2006.

Most Asian central banks – other than the PBoC – appear to have scaled back the extent of their FX intervention since 2005 (slide 9). The BoJ has not intervened at all since March that year. Most other Asian central banks have reported much smaller increases in their official reserves in 2005 and so far this year than in 2003 or 2004 – and (unlike Japan) their currencies have generally appreciated against the dollar. For most of the smaller Asian economies, currency appreciation has been one way of dampening the inflationary pressures associated with rising oil and other commodity prices.

China has of course continued to accumulate official reserve assets even though it no longer maintains a rigidly fixed exchange rate. Although official data have not been posted since the end of September, almost certainly the PBoC’s reserves now exceed US$1trn, the largest such stash in the world. By some reckonings, China’s State Administration of Foreign Exchange (SAFE) is the world’s largest fund manager.

Although data on Asian central bank holdings of US Treasury securities is not directly available, the two charts in Slide 10 show total Asian (ie official and private) purchases of US Treasury securities and total foreign central bank (ie Asian and other central bank) purchases of US Treasury securities.

[3] Ben Bernanke, *The Global Savings Glut and the US Current Account Deficit*, Homer Jones Lecture (14 April 2005).

It would appear at least from casual inspection of the two series shown here that purchases by Asian central banks have made up the bulk of total foreign central bank purchases of US Treasury securities in recent years.

During 2003 and 2004 it seems likely that Asian central banks were directly financing up to two-thirds of the US budget deficit. They were in effect running what I've sometimes called 'the largest vendor financing scheme in the world' – lending to US consumers, via the US budget (which has been in deficit because the Bush Administration cut taxes on American consumers while increasing spending on the military, farm subsidies, bridges to nowhere in particular in Alaska and so on) the money that American consumers need to keep borrowing so that they can keep buying the stuff that Asian countries need to keep selling to them so that they can continue to enjoy export-led growth.

It is a disturbing indication of the profound ignorance of many American politicians as to the extent of US dependence on Asian central bank financing of the US budget deficit that so many of them want Asian central banks to stop 'manipulating' (as they put it) their exchange rates, apparently oblivious of the consequences for US interest rates in the (unlikely) event that Asian governments acceded to their wishes.

As is now increasingly well-known, the US TIC data are an imperfect guide to the countries of origin of foreign purchases of US securities, as they only identify the country in which the counterparty to a transaction with a US reporting entities is domiciled. Particularly since the introduction of the Orwellian-sounding 'Patriot Act', many foreign investors are fearful that their assets could be confiscated or sequestered by US authorities – and hence are increasingly routing their transactions through third countries, notably London.

While these fears are most keenly, and understandably, felt in the Middle East, a comparison between published data on changes in official reserve assets and US data on net purchases of US Treasury securities (slide 11) suggests that some Asian central banks are either also increasingly transacting through third locations, or are diversifying into other assets (or both).

Most Asian central banks would now appear to have more than sufficient levels of official reserve assets – judged by their level in relation to imports (slide 12) or in relation to short-term foreign debt (slide 13).

Indeed for many central banks a key consideration is the risk of capital loss in the event of a substantial depreciation of the US dollar – an event which could perhaps be triggered by their own efforts to reduce that risk by diversifying their holdings away from the dollar. This is a dilemma to which some Asian central banks (including the PBoC) are now giving considerable attention.

No less important, in my view, although it has attracted far less discussion in Asia, is whether the accumulation of such large holdings of US Treasury securities represents an optimal allocation of this vast pool of savings from the standpoint of the welfare of current and future generations of Asian citizens.

China abandoned its rigidly fixed exchange rate peg at the end of July last year, and although over the following 12 months there was considerable criticism from some quarters, especially the United States, over the relatively slow pace of yuan appreciation against the dollar, more recently - and especially since the advent of Henry Paulsen as Secretary to the US Treasury) and the onset of renewed weakness in the US dollar against other currencies – Beijing appears to have been willing to allow a faster rate of appreciation of the yuan (slide 14).

By contrast the Japanese yen has been remarkably weak. The contrast between the behaviour of the yuan and the yen is even more striking when examined in real trade-weighted terms (slide 15). The Chinese yuan has appreciated by about 1% in real effective terms since the abandonment of the fixed peg, to be nearly 7% above its most recent low in December 2003. By contrast, the Japanese yen has depreciated by 7¼% since China abandoned the exchange rate peg, and in October was at its lowest real effective level in 24 years.

This is despite the fact that Japan's current account surplus has been running at record levels (in yen terms although not as a proportion of GDP) (slide 16).

The yen's persistent weakness reflects the increasing outflow of capital from Japan. FDI outflows have accelerated over the past two years, and are now as large as at the height of Japan's 'bubble economy'. There has also been a dramatic acceleration in portfolio and other capital outflows.

While some of this reflects the so-called 'yen carry trade' – borrowing in yen at very low interest rates by non-Japanese investors to purchase riskier assets denominated in other currencies – the weakness in the yen over the past couple of years appears to owe more to a growing enthusiasm on the part of Japanese retail investors for foreign assets, especially high yielding ones such as Australian and New Zealand dollar denominated bonds. This is the main force behind the growth of the Uridashi bond market.

With Japanese interest rates likely to remain well below those in other financial centres for an extended period, and Japan's ageing population driving a growing willingness to bear currency risk in order to attain higher levels of retirement income, these outflows may become an even more important element in regional capital flows over the next few years, rather than being an ephemeral phenomenon as widely thought as recently as a year ago.

By contrast with the enormous amount of academic and political attention has been devoted to the emergence of developing east Asian nations, very little attention has been paid to the emergence of an even larger pool of capital in recent years among oil-exporting nations (slide 17)[4].

According to the IMF's most recent *World Economic Outlook*, whereas East Asian surpluses (including Japan's) will reach US$400bn this year and next – as they did last year – the surpluses of non-OECD oil producing nations will exceed $US500bn this year and reach US$550bn in 2007. If oil-exporting OECD nations – principally Norway and Canada – are included, then the combined surpluses of oil-exporting nations will, according to the IMF's forecasts, exceed $600bn this year and next. (These forecasts were premised on an oil price averaging US$75 per barrel in 2007, which now seems a little high).

Yet it is only this week that *The Economist*, for example, has thought this issue sufficiently important to editorialize about it[5].

---

[4] This has been one of my 'hobby-horses' for 2006: see, for example, my *The Emergence of Oil Producers as Significant Capital Exporters: Possible Implications for the Global Financial System*, Paper presented to the International Conference of Commercial Bank Economists (Milan, Italy, 22 June 2006), available at http://www.anz.com/business/info_centre/conomic_commentary/OilPricesandExternalImbalances.pdf. Another insightful piece is by George Magnus and Massimiliano Castelli, *Capital Flows and the World Economy: Petrodollars, Asia and the Gulf*, UBS Investment Research (November 2006).

[5] 'Petrodollar Power', *The Economist* Vol. 381 No. 8507 (9 December 2006), pp 10-11; see also 'Economics Focus: The Petrodollar Peg', p. 80.

Based on the IMF's forecasts, there are now four nations running surpluses in excess of US$100bn (slide 18). Three of them are APEC nations – China, Japan ... and Russia; the fourth is Saudi Arabia.

Among the world's top 20 current account surplus generating nations this year are a number of others which don't customarily spring first to mind when mentally compiling a list of major financial powers – Algeria, Libya, Nigeria, Iran and Venezuela, for example.

Most of these countries (including Saudi Arabia and Russia) maintain exchange rate regimes which are much more rigidly fixed than China's now is – yet how many pieces of legislation have been tabled in the US Congress demanding 'regime change' from their central banks on pain of punitive tariffs and quotas? (Ah – but they sell oil to the Americans, not T-shirts!).

And many of these nations are set to become substantial net international creditors over the next few years if, as seems more likely than not, oil prices remain high (slide 19).

Yet most of these countries are far less transparent in accounting for what they do with their surpluses than Asian countries are – most of their surpluses are held in semi-secret investment funds, or in national oil company reserves, rather than on the balance sheets of their central banks. (Hence the rather puzzling suggestion that Saudi Arabia will remain a net debtor despite running current account surpluses close to or in excess of US$100bn pa over the next few years).

And many of them have much more fraught political relationships with the United States than East Asian nations (including China) do.

A key question for the stability of the global financial system therefore is – how likely is it that these new financial powers will play the role of 'lender of last resort' to the United States, as Asian central banks did in 2002-2004, should that again become necessary? Perhaps this is something that APEC Leaders could spend a little time pondering when they gather together again in Sydney next September.